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**Executive Compensation**

Attorneys negotiating executive employment agreements on behalf of companies and executives need to be aware of economic trends in executive compensation. In this article, the authors review the regulatory environment and discuss the changing form and nature of executive compensation. For an in-depth discussion of legal issues affecting executive employment agreements, see Lazar & Blostein, ***Executive Employment Agreements,*** a new chapter in BNA's Executive Compensation Library Executive & Director Compensation Reference Guide.

## Changing Economy Impacts Executive Pay

BY WENDI S. LAZAR AND KATHERINE BLOSTEIN

*Wendi Lazar is a partner at Outten & Golden LLP, New York, where she co-heads the firm's Executives & Professionals Practice Group. She practices in many areas of employment law with a focus on executive agreements, including retention, expatriate, noncompetition, talent, severance, and compensation arrangements. Katherine Blostein is an associate in the Executives & Professionals Practice Group.*

### Introduction

The downturn in the economy has had a significant effect on executive compensation and on executives' leverage in negotiating the terms and conditions of their employment and equity agreements. The overwhelming outcry about excessive pay from shareholders and the public has resulted in federal regulations that limit executive pay for top executives at companies that are "bailout" recipients. In addition, there has been a return to performance-based compensation, as well as a movement toward eradicating guaranteed bonuses on Wall Street and among other bonus-based businesses.

However, because of a need for top talent in tough times and some incremental signs of recovery, companies are voluntarily paying back the borrowed federal funds in order to remove compensation restraints. Unfortunately, public opinion is not as easily assuaged. The current challenge for companies and their counsel negotiating executive agreements is to balance the need for attracting and compensating top talent against potential negative public opinion.[1] How hard and where to push becomes a concern in order to ensure that these agreements pass muster with the companies' shareholders.

With these considerations in mind, attorneys representing executives should be aware of the most recent trends, developments, and regulations that will affect negotiations in the current economy.

**1. Recent Regulations Affecting Executive Compensation.** Any attorney negotiating an executive employment agreement must be familiar with the current regulations that affect executive compensation and should know when to seek the assistance of a tax adviser or a compensation expert.

On Feb. 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (ARRA) which, among other things, amends Section 111 of the Emergency Economic Stabilization Act of 2008 (EESA) and relates to executive compensation limitations for financial institutions receiving funding under the Troubled Asset Relief Program (TARP). It is important to be aware of the limitations on executive compensation imposed by ARRA upon public companies. Under the original terms of EESA, only the five most highly paid executives of a public company receiving assistance under TARP were subject to compensation limitations and restrictions. ARRA significantly expanded these limitations and restrictions to as many as the next 20 most highly compensated employees, or to such higher number as the U.S. Department of the Treasury (Treasury) may determine is in the 'public interest.'' ARRA even goes so far as to revisit compensation determinations made before its enactment to confirm that such prior compensation determinations were consistent with TARP and not contrary to the 'public interest.' Therefore, any attorney negotiating an employment agreement for an executive who will be joining the ranks of a financial institution receiving TARP funds or on behalf of the financial institution itself must be aware of these regulations.

Under ARRA and EESA, TARP recipients are prohibited from paying or accruing bonuses, retention awards, or incentive compensation to their senior executive officers and a certain number of the most highly compensated employees during the TARP obligation period. An exception is the payment of long-term restricted stock that does not fully vest until the TARP obligation is completed, has a value in an amount that is no greater than one-third of the total amount of annual compensation of the employee receiving the restricted stock and is subject to any other terms the Secretary of the Treasury determines are in the public interest.[2]

Finally, in June 2009, Barack Obama appointed Kenneth Feinberg as an ''executive compensation czar'' to set salary and bonus levels for top executives at companies that have not paid back TARP funds, and to help design a pay structure for the many other firms that have received bailout money in recent months. While Feinberg faces a real challenge in having to dictate to bailout recipients how much and in what form their executives should be paid, his every move will be analyzed by the public and therefore, his directives may reverberate into the executive pay decisions of companies that are not using TARP money, and even into those of companies in the private sector.

In regard to the tax issues, the most important tax regulation that has recently affected employment agreements is Section 409A of the Internal Revenue Code (IRC). Section 409A was added to the IRC by Section 885 of the American Jobs Creation Act of 2004 and became effective on Jan. 1, 2005.[3] Section 409A regulates the tax treatment of ″nonqualified deferred compensation.″ The Internal Revenue Service issued initial guidance on Dec. 20, 2004, and final regulations were published on April 17, 2007. The final regulations became effective and the transition period expired on Jan. 1, 2009. During the transition period, various companies modified their plans in order to comply with 409A standards for deferred compensation and to preserve favorable tax treatment for plan participants or ''service providers'' (e.g., employees).[4]

Section 409A provides that unless a ″nonqualified deferred compensation plan″ complies with various rules regarding the timing of deferrals and distributions, all vested amounts deferred under the plan for the current year and all previous years become immediately taxable (including a 20 percent penalty tax) to the employee.[5] The result of these restrictions is that most of the details under a deferred compensation arrangement must be in writing and defined from the beginning of the deferred compensation arrangement (unless one of the exceptions from the regulations applies). For purposes of Section 409A, a deferred compensation plan is one that ″provides for the deferral of compensation if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year.''[6] Under Section 409A, a ″plan″ includes an employment agreement. [7]

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[1] *See* Stephen Labaton & Eric Dash, U.S. Weights Action Over Citi's Million Dollar Man, N.Y. Times, Aug. 15, 2009, at B1.

[2] The prohibition on incentive compensation has an exception for any bonus payment required to be paid pursuant to a written employment contract that was executed on or before Feb. 11, 2009. The Secretary of the Treasury has the authority to determine which employment contracts are ''valid'' for this purpose. ARRA instructs the Secretary of the Treasury to review bonuses, retention awards and incentive compensation paid to senior executive officers and the next 20 most highly compensated executives before the enactment of ARRA and determines whether any of those payments were inconsistent with the purposes of TARP or contrary to the public interest.

[3] *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 885, 118 Stat. 1418, 1634 (2004) (codified at I.R.C. § 409A (Supp. V 2005)).

[4] For definition of ''Service Provider,'' see Treas. Reg. § 1.409A-1(f). In addition to employees, ''service providers'' can include independent contractors.

[5] I.R.C. § 409A(a)(1)(B)(i)(II).

[6] Treas. Reg. § 1.409A-1(b)(1).

[7] For the definition of ''Plan,'' see Treas. Reg. § 1.409A-1(c). The concept of ''plan'' as covered by this § 409A includes many dif-

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With regard to short- and long-term compensation, under Section 409A, if an annual bonus is earned in one taxable year and paid in another, it may constitute a nonqualified deferred compensation plan. If an employer pays part of the annual bonus shortly after the close of the year in which the services were performed and pay the rest in a later year, the timing and nature of the payments would be subject to Section 409A and must comply with the distribution requirements under Section 409A.[8] The annual bonus must be paid in the year the services are provided or within 2½ months following the end of the employee's tax year or the employer's tax year, whichever is later (the ''short-term deferral'' rule under Section 409A) in order to avoid the application of Section 409A.[9]

Under 409A, stock options and stock appreciation rights are excluded from the treatment as deferred compensation if they meet certain requirements. In this regard, a stock option must have an exercise price no less than the fair market value of the stock on the date of grant to the employee, i.e., it cannot be discounted. Shares of restricted stock are not deferred compensation for purposes of Section 409A, but restricted stock units are deferred compensation that must comply with Section 409A. Other forms of equity compensation grants must be examined carefully to determine whether they fall within the statute's definition of deferred compensation. The application of the rules to equity plans and grants can be complicated, and careful attention must be given as to how the rules apply to a particular form of equity compensation.

**2. Changes in Executive Compensation Structure.** These new rules and regulations have significantly changed the form and nature of executive pay. Companies are designing compensation programs depending on their cash flow that are heavily weighted toward long-term rewards and are partially or wholly performance-based. The form and nature of incentive compensation differs across industries. However, any compensation arrangement for an executive must have an equitable mix of short-term and long-term incentive compensation.

***a. Short-term Incentive Compensation.*** Short-term incentive compensation is usually paid to executives in the form of an annual incentive bonus. Larger companies typically have standard incentive compensation plans describing how annual bonuses are accrued, which should be reviewed by the executive and his or her attorney. Smaller companies or start-ups may present the employee with targets and milestones based purely on performance, while other companies (particularly financial institutions) state in their offer letters that their short-term incentive compensation is totally discretionary.

Because of current developments in the economy and the scrutiny over executive compensation, many companies (whether public or private) will have to justify their allocation of annual bonuses to their shareholders. The metrics and rationale for paying out these bonuses may be based on realistic individual achievements and performance targets, including both the employee's performance, the division or department performance, and the company's overall performance throughout the fiscal year. Based on these metrics, the executive or the attorney negotiating the compensation package should insist on a clear definition of what the bonus will be based on. These metrics or the formula used to calculate them should be based on realistic expectations of the company's and executive's performance. These may include achievement of specific EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) targets, a certain level of sales, or other goals appurtenant to the executive's performance of his or her responsibilities under the agreement. However, the ''cause'' definition in executive's employment agreement should never include a performance trigger that could result in an employee being fired for ''cause'' because he, his department or the company did not reach the performance goals defined in the bonus formula.

While bonus guarantees have become less popular, they are not obsolete, especially in industries and areas of the economy that are currently in development and have a high probability of being lucrative in the next few years. However, it is expected that guaranteed bonuses for more than one fiscal year will not be offered (even to top executives), without clawbacks and safeguards to protect the company.

Finally, any employment agreement should state what will happen to the accrual of the bonus in the event the executive is terminated before it is paid, if the agreement expires before the end of the employer's fiscal year, or if the bonus is in a deferred scheme and it has not vested at termination. In the event the agreement provides for any guaranteed bonus, any portion of the guarantee that remains unpaid when the employee is terminated should be paid out to the employee (sometimes in lieu of other standard severance) because of the employee's missed opportunity cost. If no guaranteed bonus is contemplated by the agreement, the employee should at least receive a pro-rated portion of the annual bonus to the extent the employee fulfilled the detailed performance objectives described in the agreement.

***b. Long-term Incentive Compensation.*** In order to retain talent, especially in a down economy, in addition to paying annual bonuses, companies are granting more long-term incentive compensation. Long-term incentive compensation is often structured as a grant of equity or another long-term plan that will vest over a specific period of time. By granting long-term incentive compensation to employees, companies ensure that the employee is motivated to stay with the company and perform well, as the employee is now an investor in the company's losses or profits.

Long-term compensation may take the form of statutory or nonqualified stock options, restricted stock grants, phantom stock, performance shares, stock appreciation rights, and other kinds of compensation. Aside from making sure that each grant of equity or employee entitlement to future grants are referenced and detailed in the employment agreement (as well as what happens to the grant in the event of termination), it is essential that such a grant of equity compensation complies with applicable tax rules.

The new limitations on executive compensation for some public companies as well as the increased scrutiny over executive compensation will mean that equity grants must be justifiable to shareholders. These recent

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ferent types of compensation and benefit plans in which executives participate.

[8] I.R.C. § 409A(a)(2)(A).

[9] If the agreement provides that the bonus ''might'' be paid within 2½ months period, it will not meet the ''short-term deferral'' exception.

developments will result in deferred compensation being subject to not only time vesting but performance vesting. In this regard, the executive and the attorney should review all equity plans and ensure that the grants subject to performance vesting are based on realistic performance triggers and expectations. Additionally, it is expected that many companies will go back to granting stock options to executives—a deferred compensation practice that has become less popular over the last few years especially in public companies. Now, after some executives have been paid large amounts while the companies' performance deteriorated, stock option grants are expected to make a comeback. This mechanism will incentivize employees to participate in the company's success and also result in their sharing in the company's failures, as the options are worthless if the share price is below the grant price of the options.

In negotiating grants of long-term compensation, it makes sense to match the term of employment to the vesting of equity grants to ensure that the equity has a chance to vest during the employment term. Every equity plan should also contain specific information about the termination and forfeiture of the equity and a waiver and acknowledgment section in which the employee confirms his or her knowledge and understanding of the terms.

**3. Clawback Provisions.** With recent developments in the regulation of financial institutions and executive compensation, employers are frequently inserting clawback provisions into employment agreements and other executive compensation plans. Clawbacks are contractual provisions that require an employee to repay compensation if a specific event or other trigger occurs. These provisions are frequently triggered by the termination of employment, the employee's misconduct, or the violation of a restrictive covenant after employment ends.

Certain federal regulations specifically allow clawbacks of executive compensation. The Sarbanes-Oxley Act of 2002 requires that certain bonuses and other incentive compensation previously paid to a chief executive officer (CEO) and a chief financial officer (CFO) of a public company must be repaid if it is determined that their activities significantly contributed to restatement of a financial statement, and it is determined that the executive received unearned incentive compensation as a direct result of his or her own misconduct.[10] Enforcement of the clawback provision of Sarbanes-Oxley lies with the Securities and Exchange Commission, and the statute does not give private plaintiffs standing to bring a claim against the CEO or the CFO. ARRA also has a clawback requirement that calls for recovery of any bonus, retention award or incentive compensation paid to a senior executive officer and any of the next 20 most highly compensated employees of a financial institution receiving TARP funds if the compensation was based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate.

Aside from the regulatory clawbacks that protect shareholders and U.S. taxpayers, most clawback provisions create a contractual obligation to pay back incentive compensation or a sign-on bonus upon employee's termination or departure and should be carefully negotiated and drafted. In an employment agreement, the circumstances that would allow for any clawback on an annual bonus or a sign-on bonus should be limited to termination with cause or voluntary resignation without good reason. Further, any clawback trigger should be limited in time and scope. If a contract requires an executive to pay back incentive compensation, the manner and timing of the payment should be carefully planned considering Section 409A consequences, standard income tax consequences, and possible violations of wage laws that may be triggered if clawback provisions are not constructed carefully in the agreement or compensation plan.

## Conclusion

The economic downturn will continue to create new rules and trends that will affect what executives are offered and what their counsel can negotiate. Changed perceptions of what is an acceptable or appropriate compensation package will sway companies to alter and modify their equity, deferral, and bonus plans.

It will be interesting to see in the coming months how the federal government, through Congress and the Treasury, balances the need to retain executive talent at TARP recipient companies against public opinion. Ultimately, this balance will be evident in a new generation of executive employment agreements.

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[10] *See* 15 U.S.C. § 7243.

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